



BARCLAYS
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Forecasting Earnings: A Commentary

by

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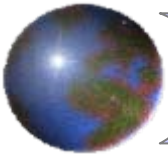
Cornell – Henrietta J. Louis Professor of Management

*CARE Conference
Atlanta, Georgia*

April 8th, 2006

CORNELL
UNIVERSITY

Johnson Graduate School
of Management



What I learned...

- **Hire Dorrn**

It's much easier than trying to digest all the stuff in his talk.

- **Next time he is presenting, give him more time**

This talk is like an adolescent, it is still growing.

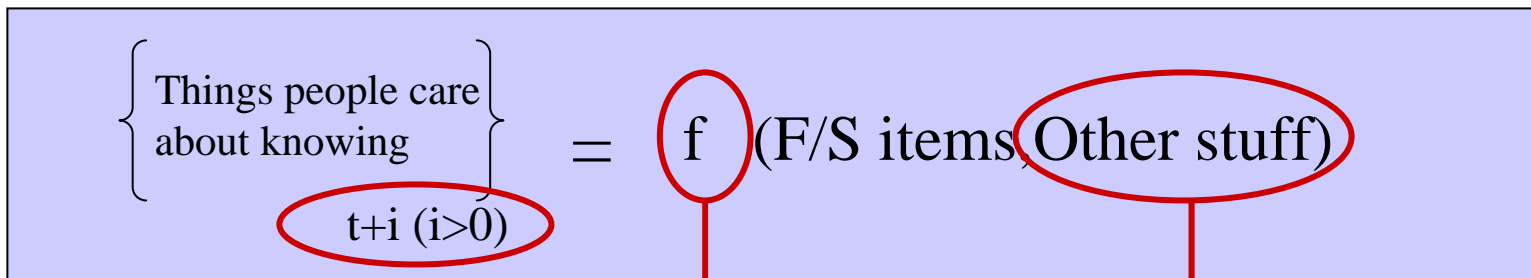
Lots of good stuff here, but it may be not easy to see the forest for the trees.

- **I should keep this short**

When you stand between Dorrn Nissim and Richard Sloan, you should get up, put up, and shut up. FAST.



FSA: A Broad Perspective



Economic outcomes of consequence to people:

- Stock returns
- Δ Risk (e.g., Credit spreads)
- Bankruptcies, prob. of fraud, corporate actions (M&A, SEO etc.), analyst revisions, index membership, implied vol., delistings, cost-of-capital, executive compensation
- Future earnings

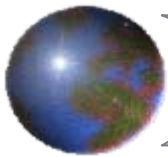
Theory:

- Valuation
- Agency
- Others

Often contextual:
Based on accounting knowledge and economic insight

Often interdisciplinary:

- Finance
- Economics
- Psychology
- Marketing
- Corporate Strategy



On earnings forecasting...

- **Why earnings?**

Pros: It's objective and available, others seem to care about it.

Cons: It is not that correlated with changes in firm value; why not something like change in analyst revisions, or ΔV (e.g., Liu and Thomas)? Book value?

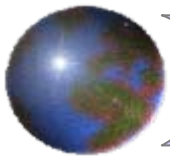
Next period's earnings is likely to be related to what I truly care about, but can we specify a more interesting target variable?

What is the economic decision of most interest?

- **What earnings?**

Should it be Operating? Core? NOPAT? Comprehensive? (Why?)

Should it be scaled? RONA? ROE? (Why?)



On earnings forecasting...

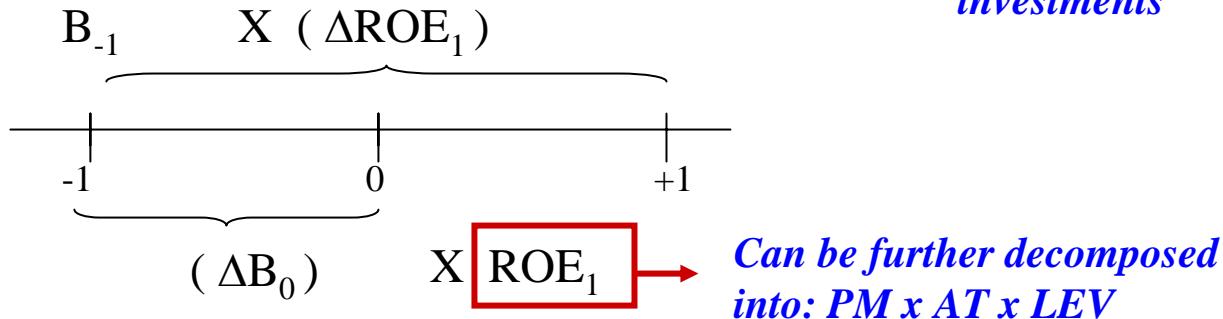
- This is a useful decomposition:

$$\begin{aligned}
 \text{EPS}_1 - \text{EPS}_0 &= (\text{ROE}_1 - \text{ROE}_0) \times \text{BVPS}_{-1} \\
 &+ \text{ROE}_1 \times (\text{BVPS}_0 - \text{BVPS}_{-1})
 \end{aligned}$$

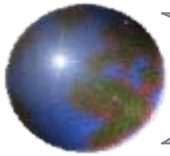
The EPS Surprise

1. *The Change in ROE on existing capital base*

2. *The return (ROE) on new investments*



What are the economic drivers of this EPS surprise? Do markets participants know about it?



A few other things...

- **Deeper contextual analysis**

There is a need to fill the gap between large sample one-size-fit-all studies, and single firm analyses

To get down deeper get into individual industries: understand the economic drivers, sources of competitive advantage and risk, and how they are reflected in the financial statements

- **Looking ahead**

FSA is COOL! It is a vibrant interdisciplinary pursuit with lots of applications. Many opportunities.

But... we need to maintain perspective, and contextualize the exercise in the broader context of information economics